Treasury and US Tax Reform

1. Introduction

The 2017 tax law provides the first major changes to the US tax code in over 30 years and it has important implications for multinational companies. The most significant is that there is now less tax incentive for multinationals to set up complex transfer pricing strategies in order to reduce US income and book profit in non-US entities domiciled in lower tax jurisdictions. The new tax law also encourages companies to repatriate cash to the US, making this a key evaluation factor for companies with significant cash outside the US.

The combination of these changes and others make it important for companies to review their offshore financial structures, liquidity management strategies and intercompany arrangements. Treasury is a key stakeholder in these assessments given the potential impact on both the treasury techniques used as well as the supporting banking services.

2. Tax Reform and Treasury

Beyond the headline items of the new tax law, there are several nuanced aspects of the new tax law that need to be considered in order to ensure that treasury processes can continue to support the business effectively:

- The Continuance of Subpart F—Subpart F is a section of the tax code designed to prevent US corporations from deferring the recognition of otherwise taxable income through the use of foreign entities known as controlled financial corporations (CFCs). The new rules move the US closer to the full territorial system common in the rest of the world meaning that US companies will pay tax only on US income, with dividends from foreign subsidiaries exempt from US tax. This is good news. However, certain income can still be construed as a "deemed dividend" or Subpart F income and is still subject to scrutiny.

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- Offshore Cash—The law introduces the concept of a tax approach that aggregates the foreign cash position based on an average calculated over a two-year period which is good news. The downside to this new treatment is that the tax does not permit common exclusions from the position such as cash for working capital needs, legal purposes or regulatory requirements.
- Intercompany Arrangements—One component of the law, base erosion and anti-abuse tax (BEAT) has a potential impact on intercompany flows. If an offshore treasury structure acting as a cash concentrator also receives non-interest related payments such as royalties or the cost of transferred goods, it is necessary to separate interest payments from other payments for the purposes of BEAT characterization.
- Interest Expense—The law introduces the concept of global intangible low-taxed income (GILTI) which could impact treasury. However, interest expense is only impacted by GILTI if it is paid to a third-party and GILTI does not apply to interest between two wholly owned subsidiaries of a US company. This should exclude intercompany cash pools but may still be subject to a different tax scrutiny related to CFCs as Subpart F is alive and well.
- IRS Section 385—Under the new law, implementation of Section 385 has been postponed and will now only apply to intercompany debt instruments issued after January 1, 2019. This means that new documentation will not have to be prepared until the third quarter of 2020. However, even before recent tax reform the 385 documentation rules were relaxed and the US Treasury determined that cash pools set up for treasury management purposes would not be required to produce the extensive documentation.

The changes outlined above have potentially significant impact on the treasury operations of multinational companies. This makes it prudent to review the types of offshore treasury structures, intercompany liquidity management techniques and banking arrangements that are commonly used and should be considered in the light of the tax law changes.

3. Offshore Treasury Structures

Tax reform targets companies that have relocated corporate headquarters or primary profit centers to an offshore lower tax jurisdiction. This attack on tax avoidance impacts traditional offshore centers that have been set up for proximity to regional customers and vendors, transportation hubs, multilingual labor pools or other operational reasons. There is also a financial aspect critical to Treasury including access to credit and currency markets, reduction of withholding tax on interest, facilitation of intercompany transactions and lowering administrative and banking costs. Treasuries commonly use an

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offshore entity to manage these types of transactions using a Special Purpose Vehicle (SPV). An SPV is a legal entity that allows facilitation of intercompany accounting flows and tax efficiency which can be designated as an offshore finance company or treasury center and may can be a component of a Shared Service Center.

One common approach used by Treasury and fully supported by Tax is an In-House Bank (IHB). This arrangement allows Treasury to act as the banker for business operations in managing certain types of transactions and cash flows—an efficient intercompany liquidity management mechanism. With the financial function centralized, business units can concentrate on operations while Treasury manages banking. IHB activities can range from simply handling all borrowing and investing for subsidiary operations to using intercompany funds in more complex arrangements with accounts held by the IHB in lieu of external bank accounts.

An IHB approach typically encompasses the following components:

- The IHB is a separate legal entity managed by Treasury. Participating subsidiaries can use the company's designated bank's API or web platform to make payments for their business activities using their IHB sub-accounts or use internal bank accounts set up by Treasury within a TMS or other system.
- Transactions across the bank accounts are recorded in the TMS or other system and these are managed as intercompany loans.
- Other intercompany loans can also be handled by the IHB.
- The IHB generates reports to charge the participants in their functional currency for banking activities.
- IHB arrangements can facilitate accounting for collect-on-behalf-of (COBO) and pay-on-behalf-of (POBO) transactions.

If the IHB charges fees or spreads to the participants, there are tax implications which must be carefully reviewed with company tax specialists as these types of transactions will most likely be impacted by BEAT or GILTI. Although an IHB arrangement can be fairly simple, it would be extremely difficult to manage without a global accounting platform/ERP (Enterprise Resource Planning) or a TMS—Treasury Management System.

A key consideration relates to offshore ownership of Treasury-related structures and pool header management as CFC rules are more complex. Tax input is required to assess present or planned ownership arrangements.

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Overall it is highly unlikely that US multinationals will dismantle offshore centralizing structures such as an IHB outside of their home country, whether managed separately or as a part of a Shared Service Center or Finance Company, because of tax reform. There are too many practical and logistical drivers which make offshore arrangements sensible and which do not compromise any tax or regulatory rules—even under the new tax laws. But be sure to keep any tax reform implications in mind if setting up new or planning changes to existing structures offshore.

Effective liquidity management does not equate to tax inversion—which is the primary target of tax reform. The liquidity management techniques that are normally handled within an offshore structure are discussed below. A review is valuable, however, to determine what if any impact there will be from the new tax laws.

4. Intercompany Liquidity Management Techniques

The offshore entity set up for managing liquidity and intercompany flows globally or within a particular region will be the primary owner of the banking arrangements and services set up to handle cash flow transactions and balances across geographies and currencies. There are three primary techniques to manage third party and intercompany cash flows and balance positions—multilateral netting, cash pooling and the use of virtual accounts. With certain caveats, none of these approaches should be impacted by tax reform as they are used primarily to facilitate intercompany flows, reduce banking and transaction costs and manage working capital across multiple currencies.

Multilateral Netting is a mechanism for the settlement of intercompany cross-currency, cross-border invoices on a set (usually monthly) basis. It allows consolidation and offset of intergroup payables and receivables on a global and multicurrency basis.

Netting works most effectively when there are several subsidiaries that are buying and selling to each other in multiple currencies. Instead of having subsidiaries pay or receive in a foreign currency the netting process manages invoices through a centralized netting center maintained by the treasury or a third party provider and nets the various bilateral transactions so that each subsidiary pays or receives in their functional currency. Multilateral netting works well from an accounting perspective. It can also be used as an intercompany liquidity management tool in several ways.

- Treasury can lead or advance a payment due to a subsidiary that is short of cash while lagging or delaying a payment due to a subsidiary that is in a long cash position—but not for more than 90 days without potential tax implications.
- Netting reduces the need for foreign currency accounts and potential idle balances.

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Other benefits include the centralization of FX management and reduction of the total number of FX transactions. Where a subsidiary does have excess foreign currency it can offer this amount to the netting center which then executes the trade with the subsidiary eliminating the trading spread typically paid to a third party.

Cash Pooling is a technique which eliminates idle cash and reduces overdrafts among subsidiary operations that have varying daily cash positions. It is a short-term cash management solution and should not be used if there is a permanent or long-term mismatch between participating entities. Cash pooling has a long history of regulatory scrutiny, most recently over potential proposals with respect to US Section 385. It is worth considering both physical and notional pooling in light of the new tax law.

- **Physical Pooling** allows funds in separate subsidiary accounts to be automatically swept to and from a header account. The participating entities are cash positive or negative at the end of the business day resulting in the subsidiary accounts being zero-balanced through debits or credits from the header account. Physical pooling can be used across multiple legal entities located in the same or different countries but there is a pool for each currency.

  Movements between accounts are categorized as intercompany loans to and from the entity owning the header account and participating subsidiaries. The holding entity should be designated as an agent for the group as this allows the characterization of interest paid and received as bank interest. Further, the holding entity does not hold stock in any of the companies so that the loans and deposits are not characterized as equity. The sweeping entries are documented daily through bank transactions and arm's length interest is paid or charged either monthly or quarterly. Physical cash pooling is a transparent and efficient liquidity management tool. The documentation and management of the cash flows leaves a sufficient audit trail that is preferred by corporate tax.

- **Notional Pooling** achieves the same result as physical pooling but it is accomplished through the use of notional positions that result in an aggregation of all the accounts, potentially even those in other currencies. Interest is paid or charged on the consolidated notional position but there is no actual movement of funds. The notional arrangement does not trigger debit interest charges or withholding tax and the participants continue to maintain their own bank accounts. The bank or system managing the notional pool provides an interest statement reflecting the net offset that is similar to what would have been achieved with physical pooling.

  Since there is no physical movement of cash, intercompany loans are not required to account for the offset. However, the arrangement requires caution because the lack of documentation and opaque nature of the implicit costs associated with it may come under tax scrutiny. For example, if one of the pool participants is tagged with a tax issue, that could cascade to all of the intercompany borrowing in

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the pool and then interest expense may be considered non-taxable and potentially would have to be treated as a deemed dividend—or Subpart F income.

In terms of cash pooling the question that arises with the new tax law is the ability of a US entity to participate in or be the legal entity owner of a cash pool. Keep in mind that Subpart F restrictions continue to exist and the interest arising from related party transactions in a notional pooling structure could be construed as deemed dividends. Although there is no unequivocal answer, the survival of Subpart F makes it inadvisable to have a US parent be part of a cash pooling structure.

Virtual Accounts are alpha-numerically defined portions of a traditional current account held with a bank. The unique identifier allows for application of transactions to an entity that are then physically debited and credited to the main current account, owned by a single legal entity. For example, receipts coming from a particular customer type or product group for credit to a specific business unit contain the detailed information that is passed to the associated virtual account. This is similar to the structure of a lockbox in the US, a much older type of virtual account arrangement. For disbursements, the use of prefixes and a higher order check sort in the US have a similar profile to virtual accounts as the funding and payments are debited from a single main account.

The primary purpose of virtual accounts is informational which allows cash application by line of business, geography or other criterion using the unique alpha-numeric identifier without the need for additional accounts. The information supplied in the virtual account arrangements greatly eases reconcilement. In their modern form virtual accounts are most effective when there is a way to automate intercompany account postings, either through the ERP or a TMS. There also needs to be an entity to hold the main operating accounts which are maintained on a currency-by-currency basis. Most likely this will be an offshore structure as non-USD currency accounts can't be held in the US. So, it is worthwhile viewing the arrangement from a tax perspective.

Virtual accounts make an ideal tool for COBO (collect-on-behalf-of) and POBO (pay-on-behalf-of) arrangements which can be handled and tracked without increasing the number of accounts maintained. The virtual account concept in its purest form would allow subsidiaries to eliminate all bank accounts—even in their home currency. Transaction information is posted to their virtual accounts, but actual crediting and debiting to the entity must be handled through intercompany accounting. Virtual accounts do not meet regulatory requirements in many countries where companies domiciled there must have a local bank account.

When evaluating virtual accounts, always keep in mind that there is potential for local regulatory scrutiny. Depending on which entity owns the main currency accounts, US tax reform will likely have no real impact on this type of banking service. But there has been discussion in the EU on cross border

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intercompany arrangements such as virtual accounts. Even such traditional approaches to funding local country subsidiaries using cost plus arrangements structures are being questioned by in-country tax authorities.

5. Tax Reform and Treasury Action Steps

Tax has always been a critical component in managing global liquidity and effectively handling related party flows. Previous sections of this paper suggest that US tax reform will not fundamentally change treasury but does offer treasury opportunities for further efficiency. Working closely with tax advisors, there are several steps that can be taken:

- Make sure treasury's objectives harmonize with the company's organizational structure and tax goals.
- Map intercompany arrangements to the company's tax and legal structure to determine which entities can be designated as principals/participants in the intercompany arrangements and how transactions between related entities will be handled from an accounting perspective.
- Examine intercompany arrangements to determine if they are arm's length and that documentation requirements can be met.
- Assess the need to set up an SPV or IHB to manage intercompany financial operations such as pooling or virtual accounts.
- Review the tax and regulatory requirements and limitations in all countries where subsidiary operations are located.
- Evaluate repatriation options under the new US tax law to determine how this will impact current or planned liquidity management techniques—particularly pooling structures.

Treasury can simultaneously use this opportunity to review banking arrangements, services and treasury processes to determine if better treasury techniques can improve efficiency, reduce costs and be compliant with tax and regulatory guidelines. Treasury should:

- Establish guidelines for bank account usage tailored to each affiliate's operational and regulatory requirements and eliminate surplus accounts.
- Match banking transactional activity and services with key bank providers to maximize access to credit, optimize bank RAROC and improve transactional efficiency.
- Decide on the most effective banking structure and services that will facilitate cash flows and intercompany arrangements with transparency required to avoid tax scrutiny.

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- Select bank partners that mesh with the company's credit needs and transactional requirements globally.
- Evaluate whether certain accounts can be handled virtually and if some collections or payments can be handled through COBO/POBO arrangements.
- Determine if the number of intercompany transactions supports the business case for multilateral netting.
- Coordinate with Accounting and IT to evaluate intercompany posting and tracking requirements, perhaps through the ERP or a TMS. This is essential for documentation and tracking from a tax perspective.
- Update or develop treasury policies and procedures covering banking, borrowing, investing, payments and risk management in order to ensure that treasury management techniques used are standardized, in compliance with local tax and regulatory guidelines and fit with the company's global tax strategy.

For many global companies, US tax reform should trigger an evaluation of potential repatriation options as well as a review of offshore structures and liquidity management techniques. Treasury must be an integral part of this overall assessment as this will insure that treasury processes, procedures, banking and technology services are aligned with both business strategies and tax objectives.

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